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The Canadian Dilemma

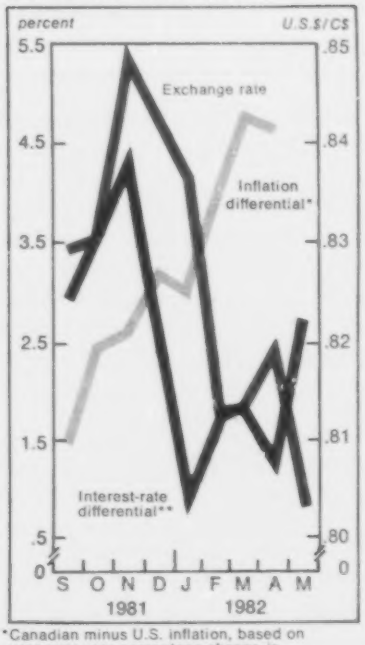
Canadian economic policymakers are faced with a number of extremely hard choices. The recession currently gripping the Unted States has had an even stronger impact on the Canadian economy. March industrial production in Canada was 11% less than the 1981 peak. Unemployment has risen to 10.2%. And unlike the U.S. experience, inflation has stayed stubbornly high, with the April Consumer Price Index up 11.3% over the past twelve months and wage increases from recent settlements tending around 12%. As a result, there has been growing pressure on the Trudeau government to take some policy action to get the economy moving again.

With high interest rates an obvious barrier to economic recovery, one suggested line of departure has been a loosening of the links between U.S. and Canadian monetary policy. The exchange market—already nervous because of the widening differential between U.S. and Canadian inflation and worsening prospects for resource prices—has responded with a sell-down of the Canadian dollar. As a consequence, the exchange rate has reached historic lows in spite of persistent large-scale intervention by the Bank of Canada.

This recent weakness of the Canadian dollar underscores the policymakers' dilemma. A decision to adopt a "made-in-Canada" interest-rate policy would almost certainly prompt a further selloff of the Canadian dollar, higher inflation, and, ultimately, renewed upward pressure on interest rates. Yet, maintenance of a significant spread between Canadian and U.S. interest rates, while implying a relatively stronger exchange rate and relatively lower inflation, threatens the possibility of a continued slide in output and employment if U.S. interest rates do not fall soon.

Given these circumstances, the government is now signaling that the policy package likely to emerge later this month or early in July will not represent a basic change from current policy. The most likely elements of the package are guidelines or controls over public-sector wages and some relaxation of the controls over foreign investment. How the exchange market will react to the package when it appears is uncertain. A clear rejection of the idea of an independent monetary policy will make for a less one-sided market for the Canadian dollar. But a package that offers little evidence of increased resolve to reduce the inflation differential between Canada and the United States would tend to confirm the bearish sentiments that now dominate.

Canada vs. the United States: Selected indicators



*Canadian minus U.S. inflation, based on year-over-year percentage change in Consumer Price Indexes

**Canadian 3-month prime finance company paper rate minus U.S. 3-month prime industrial paper rate

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Netherlands' economy expected to remain stagnant in 1982.

The Dutch Central Planning Bureau's latest forecasts project economic stagnation for the Netherlands this year, but a modest improvement in inflation compared with last year. Prices are expected to rise by between 5.5%-6% in 1982, versus 6.7% in 1981. In general, this should help to bolster Dutch exports, which are forecast to increase by 2% in volume despite a projected 12% fall in the volume of natural gas exports. However, the export strength will be more than offset by declines in private consumption, business investment, and housing construction. Against this background, Prime Minister van Agt is expected to present an interim 1982 budget to Parliament before the September 8 general election. At present, the budget proposals envisage spending cuts of some 12 billion guilders in an attempt to hold public sector borrowing to 8% of national income. This figure would equal about 9% if policies were to remain unchanged. Still, any immediate action the current government might take will have limited impact on the economy in 1982. With only half of the year remaining, significant changes in fiscal policy will not be effective before year-end, and the 1983 budget will be decided by the government that is formed after the September elections.

A shift in the trend of economic growth for Greek Cyprus.

The economic boom enjoyed by Greek Cyprus in the latter half of the 1970s appears to be over. Following the invasion and de facto partition of the island in 1974, Greek Cyprus grew at an average annual rate of some 12% so that by 1980 the national economy in real terms was some 15% larger than its pre-partition peak. The pace of growth has slowed considerably in recent years, however. Real GNP in 1981 advanced at a rate of only 2.6% following growth of 5.1% in 1980. Growth in 1982 is expected to accelerate modestly compared with last year, but it is clear that Cyprus' reconstruction period has come to an end. The government's Fourth Emergency Action Plan, which encompasses the period 1982-1986, projects that the real economy will grow at an average annual rate of 4%, based largely on expected capital intensive industrial growth. Foreign direct investment, which has grown rapidly since 1975, will continue to be encouraged and offshore banking institutions will be attracted. Tourism and manufactured goods, however will continue to be the main sources of foreign exchange earnings.

Continued depression in commodities forces Malaysia to rethink development program.

The government of Malaysia is being forced to back away from the expansionary fiscal policies that have characterized its development strategy in recent years. Persistently depressed commodity prices have resulted in widening budget and balance-of-payments deficits, putting pressure on the authorities to adopt a more austere development program—at least for the time being. The government has just announced that it intends to cut 10%-20% from this year's program. Defense spending is likely to be a prime target, but even government food and housing subsidies could be trimmed. In addition, some of the capital-intensive, heavy industrial projects are expected to be delayed or even scrapped in an effort to adjust to the adverse external circumstances.

Brazilian inflation and trade balance improving, but recovery is slow.

Brazil is making steady progress both in reducing its high inflation rate and in maintaining a foreign trade surplus position. Since late 1980, Brazilian economic policy has been shaped to lower inflation and improve the balance of payments through curtailing aggregate demand—and the government's efforts are at last beginning to yield the desired results. In the first five months of 1982, the annualized rate of inflation dropped to 91.2%, down significantly from 1981's 120.2%. In addition, over that same period, Brazil maintained a foreign trade surplus of $223 million. These gains, however, have been accompanied by a necessary slowing of economic activity. Last year real GDP declined a record 1.9%, and thus far this year there has been only slight evidence of recovery. The latest reported data show small increases in industrial activity and purchases of consumer durables. If these sectors continue to strengthen, the likelihood of positive economic growth for 1982 could be assured.

Ireland fighting uphill battle against huge budget and balance-of-payments deficits.

Ireland's new government, elected in March, has thus far remained committed to its tough policy stance, but is finding it increasingly difficult to maintain the firm posture needed to turn the troubled economy around. Real GNP in 1982 is expected to remain flat, at best, and the Irish central bank is even forecasting a 0.5% decline. Moreover, projections are that inflation will advance at a rate of more than 17% in 1982 and that the current-account deficit will be around £1.25 billion—some 10.5% of GNP. In addition, despite tax increases and expenditure cuts, the government's budget deficit will equal nearly 15% of GNP this year. To make matters worse, the government—which was elected by only the smallest of majorities—is now coming under strong public criticism for the big cuts in take-home pay stemming from increased contributions to the republic's social security system. As foreign exchange markets remain nervous about the position of the Irish pound, the Irish government is anxiously watching the economic situation elsewhere in Europe. Much of the new investment in Ireland has been in export-oriented industries, and an upturn abroad would strongly benefit Ireland's balance of payments and the domestic economy as well.

Paraguay's era of high growth may be ending.

Paraguay's years of 10%-plus rates of real economic growth may be coming to an end. Since 1977, the Paraguayan economy—bolstered by construction of the giant $18-billion Itaipu hydroelectric project—has been a standout among Latin American countries because of its high rates of real GDP growth. In addition, the country's large farming and ranching sector has sustained growth of over 8% per year in real terms. Last year, however, real GDP growth slowed to 8.5% as the economy was hit simultaneously by the winding down of the Itaipu construction, low agriculture prices, and recessions in neighboring Brazil and Argentina. The slowdown is persisting in 1982 and has been made worse by delays in starting an $8-billion joint-venture hydroelectric project with Argentina. Still, Paraguay's policy response has been one of fiscal and monetary caution, largely because of foreign exchange constraints. In this setting, prospects are that 1982 will show a lower—but still positive—rate of economic growth.

New technology critical to Taiwan's ambitious growth plans.

The government of Taiwan has set its sights on achieving 8% average annual real economic growth over the next four years. The latest four-year plan, covering the period 1982-85, calls for a major readjustment of Taiwan's trade and industry structure toward high value-added, high technology industries. In view of growing international competition in traditional labor-intensive products, priority will now be given to the development of "strategic" industries, including electrical and non-electrical machinery, transportation equipment, data processing, and electronics. A yearly growth target for this sector has been set at 14.4%, compared to only 6% for non-strategic industries. It remains to be seen whether Taiwan's overall growth aims are overly ambitious. At the moment, the economy is in somewhat of a slump relative to its past performance. Real growth for 1981 is estimated to have been only 5.5%, and despite a number of investment-boosting measures enacted by the government, little, if any, improvement is expected this year. The critical element to Taiwan's meeting its goal will be the speed with which it is able to develop or import the necessary new technologies.

Jordan enjoyed sound economy, lower inflation last year.

The Jordanian economy, led by an impressive 12.7% increase in industrial production, continued to exhibit strong growth in 1981. This was achieved by an 8.5% rise in phosphate production to 4.2 million tons as new capacity came on line and by further increases in manufactured exports to other Arab nations, particularly Iraq. The performance of Jordan's exports has been strong—up 48% to 169 dinar ($518 million). However, with domestic spending similarly buoyant, imports continued to grow by a rapid 46% to 1.05 billion dinar ($3.2 billion), implying a large rise in the trade deficit. The soundness of the Jordanian economy has also been reflected in last year's reduction in retail price inflation, down to a comfortable rate of 4.8% from 12.6% in 1980.

Will Consumers Lead the Recovery?

If the U.S. economy is going to pull out of the recession this year, most economists agree that consumers will have to lead the way. Recently, there have been some hopeful signs: Retail sales in May increased 1.5% after a 0.7% gain in April—the first reasonably hardy two-month performance since early 1981. In addition, the Conference Board's index of consumer confidence jumped 10% in May, after having declined for the previous year.

Consumer purchasing power will receive a $45-billion boost on July 1 from the 10% income-tax cut and the 7.4% cost-of-living adjustment to Social Security benefits. This and other developments will raise consumers' real income after taxes at an annual rate of better than 10% in the upcoming third quarter. It is still uncertain, however, how consumers will respond to this stimulus.

Normally, the prospect of a surge in real purchasing power would suggest a boom in consumer spending. For example, in the spring and summer of 1975, rebates on 1974 tax liabilities and a cut in 1975 tax rates boosted real disposable personal income by some 8%. Real consumption then rose at an annual rate of just under 6%, and a true recovery was under way.

These are not "normal" times, however. Unemployment is high and still rising, not falling as it was during the summer of 1975. In addition, mortgage and other interest rates have stubbornly remained at historically high levels, implying rising real interest rates as inflation slows. In contrast, real interest rates were less than zero in 1975. Moreover, in 1975, housing prices were rising at an annual rate of 10%. Currently, however, high mortgage rates are preventing existing home prices from rising and in many areas house prices are actually falling. Thus, homeowners, in general, are no longer enjoying capital gains that in the past had enhanced their spendable incomes.

Furthermore, consumers' willingness to buy on credit seems to have waned relative to earlier periods. The ratio of new consumer credit to disposable income fell one percentage point below its cyclical peak just before the 1975 recovery took off; this ratio is now three percentage points less than its early 1980 peak. Rather than signaling a pool of untapped consumer liquidity that could finance a rapid increase in expenditures, however, this greater reluctance to augment purchasing power by borrowing could be a fundamental and continuing reaction to the higher costs of credit.

These negative considerations do not necessarily imply that there will be no pickup in consumer spending —just that it may be much less than proportional to the rise in disposable income. However, if gains in consumption are to outlast the summer, consumer confidence must be further buoyed by a drop in interest rates and an improved labor market.

Latin America Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1981		BALANCE				
		6 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	us cre lions
Argentina	Real GDP dropped 5.7% in first quarter 1982; investments off 24%.	Dec.	+ 8%	128.0	$4,547	Feb.	3,484	—23%	3.6	
Bahamas	Tourist arrivals up 6% in March 1982 vs. year-earlier, but quarterly totals still below 1981.	Dec.	—16%	1.3	5,485	April	137	+20%	0.4	
Brazil	Small upturn of industrial activity and employment may signal economic recovery.	April	—11%	284.8	2,307	March	6,225	+13%	3.4	
Chile	Recession will be deep and long; GDP may decline 3%-8% this year.	March	— 2%	35.3	3,126	April	2,789	—15%	7.1	
Colombia	Conservative Party candidate wins presidential election for term starting in August.	Feb.	— 1%	37.3	1,399	April	4,336	— 8%	9.6	
Dominican Rep.	Salvador Jorge Blanco elected president; conservative economic management to continue.	March'81	+ 6%	7.3	1,314	April	184	+ 9%	1.5	
Ecuador	Economic adjustment program being implemented following May devaluation.	April	—15%	13.4	1,634	April	621	—21%	3.2	
El Salvador	Agrarian reform suspended.	Dec.	—12%	3.3	666	April	97	+ 6%	1.1	
Guatemala	Petroleum law being revised in effort to stimulate investment.	Dec.	—10%	9.0	1,239	April	190	—51%	1.2	1
Honduras	No improvement in severe unemployment problem expected as economy continues to deteriorate.	Oct.	0	2.7	710	Feb.	103	—21%	1.3	
Mexico	Tough new government austerity program will cut public spending and slow economic growth.	April	+ 4%	238.7	3,303	May	3,920	+15%	2.8	
Nicaragua	Torrential rains caused extensive damage, particularly to roads and communication system.	Aug.	+27%	2.7	1,089	Nov.	123	+40%	1.7	
Panama	Government sets $3.4 billion goal for public-sector investments during 1982-85.	Feb.	—33%	3.8	2,027	March	110	+37%	0.9	
Paraguay	Delay of Yacyreta hydroelectric project will slow construction and business activity.	Feb.	—24%	5.4	1,664	April	798	— 1%	14.4	
Peru	Industrial sector plagued by stiffer competition because of overvalued sol and import liberalization.	March	—17%	21.0	1,160	Dec.	1,209	—39%	3.7	3
Puerto Rico	Drop in employment caused by industry slowdown and public-sector austerity.	March	—16%	11.7	3,658	March	11,285*	+16%	18.0	
Uruguay	Real GDP declined by about 1% in 1981; greater drop expected this year.	Dec.	— 7%	10.9	3,711	July '81	402	— 5%	2.9	
Venezuela	No growth expected as fiscal and monetary policy tighten.	Feb.	— 8%	69.4	4,454	April	7,363	—13%	7.6	

*Commercial bank deposits

Net Borrowed Reserves: a Misleading Indicator

The figure reported each week for net borrowed reserves (NBR) is probably the second-most closely-watched monetary statistic released by the Federal Reserve. Defined as the difference between reserves borrowed at the discount window by member banks and reserves held in excess of requirements, NBR is considered to be an indicator both of money market conditions and of Fed policy. Its erratic behavior, however, has cast doubt on its usefulness in either of these roles. For example, during a recent seven-week period, NBR plunged from over $1 billion to a net "free" position in which excess reserves exceeded borrowings—and back again to a large net borrowed position.

NBR has come to be relied upon as an indicator of money market conditions, because it usually leads short-term movements in the federal funds rate. Since banks are generally reluctant to borrow at the discount window over long periods of time, increases in borrowings are usually quickly refinanced in the federal funds market, driving up the funds rate. Similarly, declines in borrowings generally signal declines in the funds rate. This relationship is valid, however, only if the reported figure for NBR is close to the amount that banks desire and if the level of excess reserves is stable and close to zero. This may not always prove to be the case. For example, much of the recent volatility of NBR appears to be attributable to computer errors. In some other instances, a disproportionate amount of excess reserves may be held by some of the smaller regional banks that do not always immediately reinvest those reserves in the federal funds market. Under these circumstances, the usefulness of NBR as an indicator of money market conditions is severly diminished.

NBR is also problematic as an indicator of policy. Contrary to some simple interpretations, an increase in NBR does not necessarily indicate a Fed tightening. NBR and non-borrowed reserves, supplied through open market operations, must sum to required reserves. But under current Fed procedures, required reserves are determined by the level of deposits held in the banking system two weeks earlier. Consequently, for a given set of policy targets, changes in M1 tend to be self-correcting. For instance, if M1 rises, required reserves rise two weeks later. The Fed has a choice of policy actions: It can either accommodate the increase in money by raising its non-borrowed target to leave NBR unchanged, or institute a "passive tightening" by maintaining its non-borrowed target and allowing NBR to rise. The latter would push the funds rate up and slow money growth. However, because of this automatic stabilizing mechanism, and because Fed reserves targets are not announced, observers of NBR cannot know at any particular time whether a change in NBR represents an active change in policy or a passive reliance on existing policies. Thus, even if changes in NBR could be used to predict short-term movements in interest rates, they would not give a clear signal of the Fed's policy intentions over the longer term.

OF PAYMENTS		MONEY AND BANKING							COUNTRIES
e of IMF dit, mil- of dollars	current influences on payments	12-month changes: latest data	consumer prices	latest data	money supply(M1)	exchange rate in U.S. dollars June 16, 1982	change from year earlier	current monetary conditions	
0	Import restraints expected to result in 1982 trade surplus.	May	+128%	May	+132%	.000071	−73%	Interest rates decline as money supply eases.	Argentina
0	Private capital inflows rising.	Feb.	+ 7%	Jan.	+ 5%	1.0100	0	Bank loans up in January.	Bahamas
0	Imports decline faster than exports to produce trade surplus.	May	+ 91%	April	+ 74%	.0070	−44%	Open-market operations limit money growth.	Brazil
30	Current-account deficit may shrink to $2.6 billion from $4.8 billion in 1981.	April	+ 6%	Feb.	− 8%	.0247	− 9%	Real interest rates continue high.	Chile
0	Coffee export prices cut to stimulate demand.	March	+ 25%	April	+ 24%	.0167	−20%	Restrictions eased on private foreign loans.	Colombia
21	Int'l. payments prospects bleak owing to low world sugar and metal prices.	Oct.	+ 6%	Jan.	+ 12%	Par	—	Monetary policy is tight.	Dominican Rep.
0	New exchange rate may boost exports.	March	+ 14%	March	+ 11%	.0271	−23%	Rise allowed in interest-rate ceilings.	Ecuador
43	Land reform setback prompts U.S. Senate to slash Reagan military aid request.	Dec.	+ 12%	Jan.	− 2%	.4000	− 1%	Net foreign assets weak.	El Salvador
7	Bumper sugar crop of some 521,000 metric tons forecast for this year.	Dec.	+ 9%	Dec.	0	Par	—	Foreign exchange available in private banking system.	Guatemala
53	Agricultural production expected to drop because of torrential rains.	Dec.	+ 11%	Feb.	+ 1%	.5000	0	Net foreign assets down sharply.	Honduras
0	Oil exports rose in May.	May	+ 45%	Jan.	+ 33%	.0210	−49%	Money growth limited to net foreign-exchange inflows.	Mexico
12	Adverse weather indicates grain, coffee, and cotton production will fall.	July '81	+ 28%	Oct.	+ 44%	.0995	0	Net international reserves decline.	Nicaragua
19	New $225 million Euroloan secured.	Feb.	+ 5%	Dec.	+ 10%	Par	—	Domestic credit available.	Panama
0	Low commodity prices limit exports.	Feb.	+ 6%	Oct.	+ 8%	.0079	− 1%	Monetary policy is restrictive.	Paraguay
12	Mining output decreased 4.4% in 1981; no growth likely this year.	April	+ 61%	April	+ 46%	.00155	−38%	Reserve requirements reduced.	Peru
—	Exports to non-U.S. markets increased.	April	+ 5%	March	+ 7%	Par	—	Business loan growth slows.	Puerto Rico
0	Devaluation pace for Sept.-Oct. accelerated to 30% per annum.	March	+ 22%	Dec.	+ 7%	.0867	− 7%	Real interest rates remain high.	Uruguay
0	OPEC production strategy working; Arab marker crude recovered to $34/barrel.	April	+ 18%	Dec.	+ 10%	.2335	0	Deposit growth continues flat.	Venezuela

World Interest Rates

market rates as of June 16, 1982; bond yields as of June 11, 1982

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	12.00	16.20	12.50 intervention rate	14.00	9.50	7.50	19.00 penalty rate 22.00	8.00	5.50	5.50
Day-to-Day Money	14.375 June 17	16.00	12.75	12.50	16.00	9.00	20.50	9.00	5.375 1-month Euro-Swiss fr. rate	7.375
Treasury Bills 91-day, Middle Rates	12.33 discount basis	16.20	12.25	15.00	n. a.	n. a.	18.60 71 days	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	13.75 finance paper discount basis	16.85 finance paper 15% tax w/h	11.60	13.90 Certified	15.63 interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	14.05	16.65 15% tax w/h	12.25	13.90 Certified	not traded	9.40	22.50	no market	6.00	no market
Government Bonds Long-term, new and old issues, average yield	13.91	16.00	12.97	10.82 25% tax w/h	15.70	9.06	20.84	10.33	4.75	8.00
Industrial Bonds prime, long-term, new and old issues, average yield	15.15 Aa Industrials	17.40	14.51	15.48	16.70	9.25	20.84	11.16	6.113	6.69
Bank Short-Term Rate to Best Borrowers (prime rate)	16.50	17.50	13.50	17.50	18.05	12.50	21.75 ⅛ qtrly fee on outstdng	10.50	9.50	6.00
Bank Time Deposits 3-month	14.25 Cert. of Dep.	17.30	12.75	15.00	15.625	9.00	11.50	9.00 large deposits	4.75 residents only	3.75 20% tax w/h
Eurocurrencies 3-month, asked	15.563	17.250	12.875	no market	16.625	8.875	no market	8.938	5.438	7.250
Exchange Rates—in U.S.$ rates floating against the $	—	.7792	1.751	.0215	.1480	.4104	.00073	.3724	.4762	.00394
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	1.734 *D*	2.843 *P*	1.975 *D*	1.077 *D*	6.794 *P*	5.464 *D*	6.758 *P*	10.374 *P*	8.394 *P*

Eurodollar Deposits
(London, interbank, bid)
June 17

7-day	14.75
1-month	15.063
3-month	15.625
6-month	15.75

International Arbitrage
(3-month, hedged) ✚ *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−2.593
U.S.-Canada Treasury Bills	−1.293
U.S.-Canada Finance Co. Paper	−1.135
Eurodollars-U.K. Local Auth. Deposits	− .093

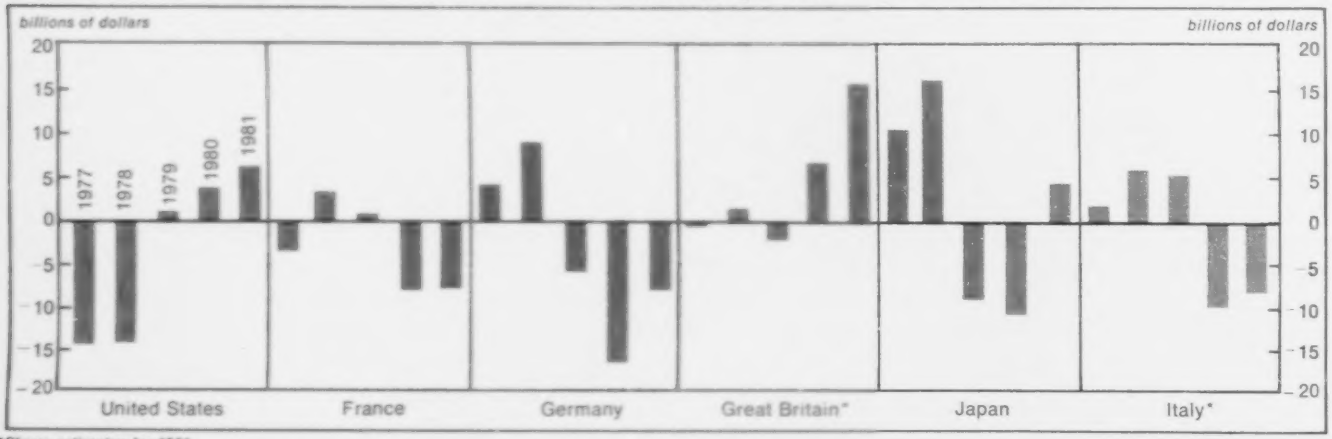
Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	15.43
Over 7 yrs.	15.50
DM Bonds	
7 yrs. and under	9.31
Over 7 yrs.	9.31

Gold Price
London afternoon fixing
317.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Current-account balances of major industrial countries



*Chase estimates for 1981

A Long Road Back for Thrifts

The recent upturn of interest rates is the latest—although undoubtedly not the last—turn of the screw for beleaguered savings and loan associations (S&Ls) and savings banks. While at current levels short term rates are still below those in the earlier months of 1982, on average thrifts will require considerably lower interest rates to attain anything approaching healthy earnings. Moreover, even with the lower rates, a lag of as much as 6 to 12 months will be required before funding costs will incorporate the lower rates to an extent sufficient for a material turnaround of profits. And finally, whether consumer deposit flows will revive as earnings strengthen is a particularly worrisome question. In this light, it seems doubtful that a strong improvement in new lending activity by thrifts—and, by extension, new housing activity itself—will materialize during the next 12 months.

The principal cause of the deterioration of S&L positions has been the rapid rise of their funding costs relative to returns on mortgages (see chart). In the second half of 1981, the margin between average mortgage returns and average funding costs for S&Ls fell to a negative 150 basis points. Even during the high-rate environment of the mid-1970s, this margin did not fall below a *positive* 125 basis points. The 1981 slump entailed an operating loss in excess of $4.5 billion, and since year-end 1980 the ratio of net worth to total assets has dropped to 3.8% from 5.3%.

The dramatic rise in thrifts' costs has reflected the sharp increase of short-term interest rates and also the greater recourse to interest-sensitive money market vehicles for funding. At the same time, however, the bulk of S&L mortgage holdings—which constitute about 80% of their interest-bearing assets—still carry interest rates well below current funding costs. According to a recent Federal Home Loan Bank study, at the end of 1980 about two-thirds of S&L mortgages carried interest rates of 10% or less, and three-eighths of the total had rates less than 9%. But even the newer mortgages, with rates above 10%, have also meant problems. During parts of 1979-80 and most of 1981, extensions of new mortgages were being made at times when there was a relatively small spread between costs of new money market funding and new mortgage yields. Thus, in the short run, the new lending contributed little to S&L interest margins. As interest rates continued to rise, sizable amounts of relatively new mortgages joined old mortgages "under water" relative to funding costs.

Recent policy measures

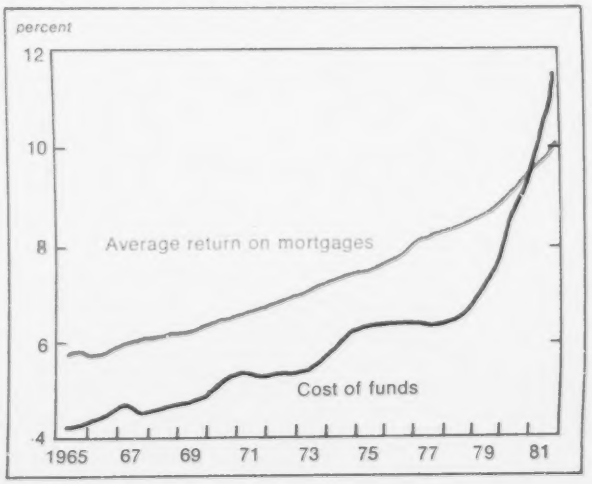
Within the last two years the government has initiated a number of new policies directed toward alleviating S&L earnings problems—either by changing certain aspects of the mortgage instrument itself or by affecting the profitability and capital of the thrifts.

On the mortgage side, under omnibus banking legislation in 1980, state usury ceilings on mortgages were preempted and thrift operating powers were expanded. In another move in 1981, the Federal Home Loan Bank Board (FHLBB) removed previous limits on the size and frequency of interest-rate changes for adjustable-rate mortgages. According to the revised regulations, contract rates may now be tied to any index that is easily verifiable.

While these two steps encouraged *new* mortgage activity, a third has addressed the *old* mortgage problem. As such, it may play an important role for many institutions' near-term profit performance. Specifically, accounting conventions have been adopted to permit changes in the time-pattern of returns on "underwater" mortgages. Under this program, the carrying values of mortgages may be reduced to their current market valuation on the basis of current interest rates and remaining term to maturity. Thereupon, in addition to the stated interest, part of the accretion of value between the market value and the original stated value may be taken into income. The estimated accretion is based on the expected *effective* maturity of mortgages, rather than the *stated* maturity. Typically, a new mortgage having a 30-year original maturity will be liquidated in approximately 10 years. On the other side of the ledger, the valuation loss represented by the markdown of old mortgages to current market value (to be carried as an asset, "good will") may be written off against earnings over the period of the remaining term to *original* maturity.

Several other measures relating to profitability and capital have been undertaken or are under consider-

The source of recent S & L difficulties



A Long Road Back for Thrifts *(continued from page 7)*

ation. In 1981, S&Ls were authorized to trade in financial futures. This power, along with adjustable-rate mortgages, is critical to the better management of interest-rate risk. Another measure, now before the Congress, would authorize capital contributions to thrifts (and also banks) experiencing serious erosion of net worth. The infusion would not be cash per se, however, but rather, an interest-bearing certificate. In effect, this legislation would seek to "buy time"—that is, to forestall supervised mergers or liquidations of those entities deemed to be temporarily weakened.

This "buying time" approach seems to have considerable appeal to policymakers. First of all, the legislation would insulate against the need for supervised consolidations if net worth of a thrift institution fell below the minimum acceptable level—a strong plus since the commitment of funds needed for such actions could be sizable. Second, regulators and legislators, thus far, have demonstrated considerable aversion to commercial bank acquisitions of S&Ls. Indeed, public officials convey the distinct impression that consolidations with commercial banks would be tolerable only if no other alternative is available.

One reason for the policy aversion to bank-S&L consolidations has been concern that interstate banking restrictions at the consumer level would effectively be breached. In a variety of ways, of course, this has already happened. And new developments now in the works, such as the sharing of automated teller machines, will further reduce interstate barriers. Another impetus has been desire on the part of the thrifts to preserve their separate identity as an industry (and certain regulatory preferences associated therewith). And a third has been uncertainty over the source of housing finance in an era of less specialized, multi-purpose deposit intermediation. On this count, however, recent history strongly suggests that specialization has enhanced the vulnerability of the S&Ls and hence reduced the availability of housing credit.

In a longer-term perspective, the FHLBB has proposed a substantial expansion of the list of services S&L subsidiaries are permitted to perform. The list includes: broadly expanded leasing and lending, securities brokerage, futures positioning, mutual fund distribution and management, general insurance underwriting, and real estate brokerage and development. A final decision by the board is believed to be imminent. While such authorization would have relatively little effect on S&L profitability in the immediate future, over time, strong and aggressive S&Ls would be in a position to significantly enhance their positions as sources of a wide range of financial services. Furthermore, the expanded services would make S&Ls more attractive acquisition prospects.

Interest rates and earnings

In the final analysis, a substantial improvement of S&L earnings still hinges on lower interest rates. Lower interest rates would reduce, if not eliminate, the drag on earnings from the low-rate mortgages that are such a sizable component of many S&L portfolios. Moreover, the positively sloped yield curve in effect for the past six months or so provides an attractive margin for new mortgages. As of mid-June, short-term interest rates (as reflected by the 6-month Treasury bill rate) were almost 350 basis points below new conventional mortgage yields. Intermediate-term Treasury issues have been approximately 150 basis points over 6-month bills. While the short funding of fixed-rate, long-term mortgages imposes the risk of rising interest rates, tying mortgage returns to instruments such as 3-year Treasury coupon issues would still provide a positive net return and reduce the interest-rate risk.

Whether deposit growth will benefit from lower interest rates is uncertain. The shift of consumer savings to money market mutual funds has been especially painful to S&Ls. Accelerating deposit volumes are critical in that they are the key to stronger asset growth, which in turn is a key to improved earnings on a sustained basis.

Current projections are that for S&Ls to return to a "break even" point would require a fall in short-term interest rates to at least (roughly) 10%. This prospect is also predicated on at least four major conditions: (1) a more or less constant composition of S&L funding between lower-rate "core" deposits (such as passbook savings and NOW accounts) and rate-sensitive funds, (2) growth of new mortgages at a rate comparable with that of liabilities, (3) a somewhat better rate of turnover of old mortgages than has been experienced recently, and (4) moderately strong—8%-10%—net growth. The 10% interest-rate threshold would have to be even lower if there were a materially faster shift from core deposits to other liabilities, if net new funds were allocated to market instruments of relatively short maturity (where spreads are smaller), or if the turnover rate or asset growth were lower. Thus the "magic" 10% rate level is virtually surrounded with caveats.

There are signs that thrifts are recognizing the serious long-term risks of their deposit losses. After a period of primarily defensive strategies, thrifts seem to be moving toward a more vigorous marketing stance. The development of new mortgage and deposit-like services and extended promotion efforts are indications of a new resolve toward market positioning. If sustained, and if the interest-rate decline materializes, thrifts may be establishing the groundwork for a major period of recovery.

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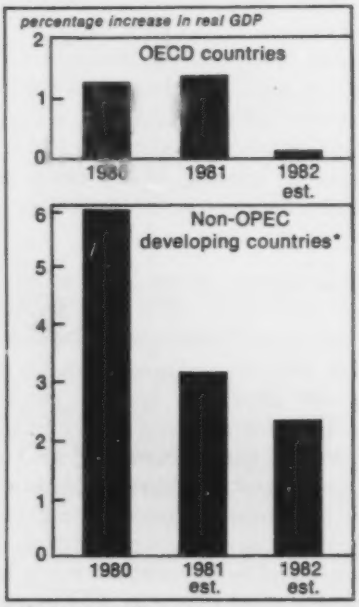
Slower Growth in the Developing Economies

The growth slowdown that has gripped the industrialized economies for the past two years is now a global phenomenon. Last year the weighted average increase of real GNP in 22 non-OPEC developing countries, including the 16 largest other than the People's Republic of China, was about 3%—down sharply from the roughly 6% increase recorded in 1980. This year the projected increase in output for this set of countries is even less—2.3%, approximately the same as their population increase. But while overall growth in these economies in 1982 is not expected to be all that different from their performance in 1981, the aggregate numbers tend to hide the fact that this year's slowdown is far more widespread. The abrupt deceleration of real GNP in the non-OPEC developing countries in 1981 was largely confined to Latin America, with significant output declines in Argentina and Brazil contributing heavily to the zero-growth record of the region as a whole. This year, even the high-flying economies of East and Southeast Asia will register markedly lower increases in the level of economic activity.

Growth of developed and non-OPEC developing economies



* Aggregation of 22 countries.

This decline in the growth momentum of the developing countries further clouds the prospects for a significant early recovery in the industrialized economies. Over the period 1976-81, the volume of exports from the industrialized nations to the non-OPEC developing countries grew at an average annual rate of 7.4%. Although data are fragmentary, the evidence now suggests that this important segment of world trade is contracting in real terms. In the 14 non-OPEC developing nations for which complete trade data are available, the volume of total imports in the first quarter of 1982 was down approximately 7% from the same period in 1981. And with an increasing number of countries encountering balance-of-payments funding difficulties, this decline in developing-country imports seems likely to continue.

The exports of the non-OPEC developing economies are also falling, but by a smaller amount than imports. Earlier projections that the balance-of-payments funding needs of this set of countries would be the same or slightly larger this year than in 1981 now seem overstated. The forecast reduction in the deficit on merchandise trade of the non-OPEC developing economies, stemming from their slower growth, appears likely to outweigh the continued deterioration of the services balance. This would leave the overall funding gap for 1982 somewhat reduced from last year's level.

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Decline in British interest rates likely—but may be limited.

Recent statistics show that the growth of Britain's money supply is now within the government's 8%-12% target range—the first time that its monetary objectives have been met since the Thatcher government came to power in 1979. This and a steady decelaration in inflation have led to expectations that a significant reduction in interest rates from the 12%-13% levels seen in recent weeks is imminent. However, the scope for a decline may be limited by the strength of the dollar, which has taken sterling's exchange rate close to 1.70, the lowest in five years. Although sterling has been reasonably strong against most other currencies (it has again risen to 4.30 against the DM) the sterling/dollar rate still plays an important role in influencing Britain's inflation rate. The government is not likely to want to see any further sterling weakening for fear of the effects on the anti-inflationary stance of its policies. Thus, despite the high probability of a small reduction in U.K. interest rates, a large and sustained decline must wait for the emergence of a similar trend in the U.S. economy.

No rebound for the German economy this year.

The latest figures show a distinct weakening of the German economy. Industrial production was off in late spring and industrial order volume declined markedly—largely the result of an 8% fall in orders from abroad. On a more positive note, inflation pressures have eased: Industral unit labour costs in the first quarter have risen by less than 3% and import prices in May were up only 0.5% from their year earlier level. Annualized consumer price inflation in the first half of 1982 was under 4%, and no underlying acceleration is expected. Accordingly, the Bundesbank appears to have shifted to an easier monetary stance: Discount quotas were raised by 5 billion DM in June despite rising dollar interest rates and "Central Bank Money" has been allowed to grow somewhat above the upper end of the 4%-7% target range. Nonetheless, the easier monetary conditions are unlikely to stimulate domestic demand before early 1983. Consequently, 1982 will be another disappointing year, with economic growth virtually certain to fall short of the government's 1%-1.5% forecast.

Forecasts of Austrian economic recovery may prove optimistic.

Some signs of recovery have emerged in Austria, prompting the nation's two leading economic research institutes to forecast growth rates of 1.5%-2.1% for 1982, with an acceleration to 2.5%-2.9% next year. Both institutes see the rebound as consumption led; investment is expected to decline by between 2%-3% this year and to recover only weakly next year. Inflation is expected to decline, both this year and next, to about 5% in 1983. While the inflation forecasts appear to be on target, the growth forecasts might prove somewhat optimistic for Austria's export-dependent economy. Recent indicators in Germany—Austria's single largest export market—point to weaker-than-previously-expected growth, which could affect Austrian exports and reduce the anticipated improvement in the current account of Austria's balance of payments.

Argentina strives to reactivate economy despite high inflation.

The Argentine government has initiated a number of measures to see the economy through its current troubled times. Following a 21% peso devaluaton and the creation of a two-tier foreign exchange market, merchandise exports and imports were placed in a commercial market with the exchange rate set daily by the central bank. All other transactions will clear in a financial market in which the rate is floating. In addition, a two-tier local-currency market has been created, with controlled deposit and loan rates in one segment and free rates in the other. The controlled market offers government-guaranteed deposits and negative interest rates on loans in an effort to bolster business liquidity. Companies that increase employment will get preferences in the controlled market. Credit expansion in the free market will be regulated by the central bank to avoid inflationary money growth. Banks are being encouraged to extend debt maturities for both foreign and local-currency loans. Other measures include forward exchange cover for foreign loan extensions. Yet, with wholesale price inflation averaging over 170% in the past year, initial business reaction to the program has been cautious and a period of market testing will be needed to gauge the response.

Chile devalues peso to help stem rising social costs of recession.

The specter of a severe and prolonged recession prompted strong policy actions in Chile last month. Most significantly, the Chilean authorities broke away from the three-year fixed parity policy and, on June 14, devalued the peso by 18% to 46 pesos per dollar. This is to be followed by an 0.8% monthly devaluation against a basket of currencies over the next year. In addition, measures were introduced to contain the growth of real wages and of a budgetary deficit that was developing rapidly as a direct result of the economic deterioration. By lowering local operating costs and restoring some of the peso's international competitiveness, these measures ought to contribute to reducing the costs of the recession in terms of bankruptcies and unemployment. However, this will happen only if the exchange rate adjustment is perceived to be adequate in light of the considerable overvaluation of the peso that has occurred over the past three years. This is crucial to avoid stimulating speculative capital outflows or discouraging external borrowing and to keep domestic interest rates from rising even higher as a result of greater demand for local funds.

Growing external debt burden weighs heavily on Sri Lanka.

The big surge in investment spending undertaken by Sri Lanka since 1977 has been financed largely through foreign savings. Consequently, the country's level of public and publicly-guaranteed external borrowing has risen rapidly in recent years: External debt outstanding climbed to $1.76 billion by the end of 1981, some 40% of GDP, compared with $782 million or 20% of GDP at the end of 1977. Particularly noteworthy has been the increase in commercial borrowing, which rose to $472 million or 26.8% of total debt at the end of last year from only $42 million or 3.8% of total debt just two years earlier. The high cost of this recent commercial borrowing, added to the repayment of outstanding loans from the IMF, pushed Sri Lanka's debt-service ratio to .17 in 1980 and 1981 from .13 in 1979. Given the poor medium-term prospects for exports, the debt burden could rise even more rapidly over the next several years unless steps are taken to boost domestic savings and to contain commercial borrowing, in particular.

Hong Kong monetary authorities demonstrate desire to stimulate economy.

The generally tight connection between Hong Kong's interest rates and world market rates may be loosening up somewhat. In response to an easing of monetary policy, the Hong Kong Association of Banks at the end of May lowered prime loan rates by one percentage point to 15%—the first such decline since last December. Underlying the monetary easing was the authorities growing impatience with sluggish export markets and a stagnant real economy. In the first five months of this year, exports rose only 6% in value and were flat in volume terms—a disappointing performance for this high-growth, export-dependent economy. The domestic sector has not been strong either. There was, however, some good news: Inflation slowed and capital inflows increased in response to tax measures taken in February. This apparently gave the government room for maneuvering.

Current-account surplus of United Arab Emirates contracting as oil revenues wane.

The continued softness of the world petroleum markets is shrinking the current-account surplus of the United Arab Emirates. Last year, the federation's export revenues fell by 4% as oil receipts suffered from an 18% drop in output that more than offset an increase in the average per barrel price to $36.15. At the same time, UAE imports of goods and services, as well as transfer payments, rose by an estimated 8% to $13 billion. This resulted in a substantial contraction in the current-account surplus to $8 billion from $10 billion in 1980. The erosion of the surplus is expected to be even larger this year, however. Reflecting the weakness of world demand, oil prices were reduced in the first quarter and are likely to average $34.50 in 1982—almost 5% lower than last year. Oil production is also down sharply and is expected to average no more than 1.3 million barrels per day compared with 1.5 mbd in 1981. If this forecast proves to be correct, gross oil revenues could drop 21% this year to $15 billion and total exports to about $17.5 billion. Furthermore, should imports and transfer payments rise again by a modest 8% to $14 billion, the UAE would register a current-account surplus of no more than $3.5 billion.

BEST AVAILA

An Easing of Pressures on the Fed

Policymakers at the Federal Reserve can breathe a little easier now. After having one of the key policy variables—the money supply as measured by M1—above the upper end of the Fed's target range for the first half of the year, M1 finally declined sufficiently in late June to fall within the target bands. In fact, by falling some $9 billion in the three weeks ending June 30, M1 was dangerously close to the lower end of its target. This information was favorably received by the financial markets, with drops of more than 100 basis points in 3- and 6-month Eurodollar rates to levels below 15%, and similar declines in rates on futures for September and December delivery.

It is unlikely that these declines could have occurred without such a dramatic fall in the money supply. The higher interest rates earlier in June reflected the market's anticipation of a huge increase in M1 in the statement week ending July 7, and of subsequent tightening by the Fed. As of now, however, even after last Friday's most recent jump in M1, the Fed is not in any serious danger of exceeding its targets by year-end.

Of course, the possibility still exists of a reacceleration of money demand later in the fall. The question of whether short-term interest rates would rebound accordingly, however, is not clear. If M1 does not rise far enough to exceed the upper end of its target, there is no reason to expect the Fed to tighten, pushing rates up. In fact, the possibility of another firming move becomes more remote as the year progresses with M1 still within target.

The relationship of M1 to its targets and the recent behavior of the money supply are certain to be of prime importance in Fed Chairman Volcker's congressional testimony this week. Previously, there had been speculation that he might propose raising the 1982 targets—either explicitly or by raising the base to which the targets are applied. This now seems unlikely, however. With the July bulge past and—because of the previous declines in M1—not particularly damaging, pressures to bring the aggregate back into target have subsided. Moreover, there have been some positive signals about the state of the economy: chiefly, improvements in retail sales (despite the June decline, they have risen at a rate of 6½% since January) and the positive "flash estimate" of GNP. Volcker now has some evidence to counter charges that the restrictiveness of monetary policy has retarded the prospects for economic growth. Consequently, there will be fewer pressures on the Fed to propose expansionary targets for 1983, as the chairman can point to the improvements on the inflation front as evidence of the benefits successively lower monetary growth targets have brought.

Africa and Middle East Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1981		BALANCE O				
		6 months ending	change from year earlier	in billions of dollars	$ per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use of credit, lions of
Algeria	State oil company cutting down liquified natural gas expansion plans.	April	−28%	36.0*	1,935	May	3,012	−16%	3.7	
Botswana	Slump in diamond prices forces belt-tightening; personal tax increases being considered.	March	−41%	1.1	1,280	May	286	−14%	4.7	
Cameroon	Draft budget for fiscal 1982/83 shows 29% increase in government spending.	May '81	−21%	7.8	890	Dec.	85	−55%	0.5	
Egypt	New five year plan (1983/84-1987/88) approved; program aims for 8% annual economic growth.	Dec.	−11%	22.7*	535	Jan.	1,354	+35%	2.0	8
Guinea-Conakry	Hosting of 1983 OAU Conference will lead to major building program.	n. a.	—	1.5	270	n. a.	—	—	—	—
Ivory Coast	Cocoa crop forecast to exceed last year's 405,000 tons.	Nov.	−28%	9.8	1,190	March	4	−73%	0	35
Madagascar	Economy appears to be stabilizing after last year's 9% decline in output.	Dec. '80	−27%	3.8	420	May '80	9	−80%	0.2	8
Morocco	New foreign investment code allows 100% foreign equity holdings in domestic companies.	Nov.	− 1%	18.1*	896	April	499	+89%	1.5	74
Nigeria	Compulsory import deposits and increased import duties hamper industrial output.	April	−34%	86.8	1,125	April	1,237	−86%	0.8	
South Africa	Real economic growth expected to slow to 1% this year and to zero in 1983.	April	−25%	81.9	2,720	May	503	−44%	0.3	
Sudan	Lack of foreign exchange for essential imports hampers industrial production.	Dec.	− 2%	9.0	482	May	21	−28%	0.2	52
Tunisia	Agricultural sector to receive investment funds of $2.6 billion—19% of total—during 1982-86.	Dec.	+ 2%	8.1	1,240	May	496	− 6%	1.5	
Zimbabwe	Budget deficit near $500 million expected to bring spending cuts and higher taxes.	Aug.	+22%	6.2	815	Sept.	200	−37%	1.6	
Kuwait	Consumer price index rose 7.3% in 1981, marginally higher than the year before.	April	+27%	26.5	18,070	May	4,170†	+ 7%	7.0	
Oman	Government budget projects 1982 expenditures of $4.3 billion, up 6% from previous year.	April	− 1%	4.8*	5,380	April	1,080	+21%	7.7	
Qatar	Qatar Petrochemical Company raising $60-million Euroloan.	April	−32%	5.0*	23,100	Sept.	347†	−10%	2.5	
Saudi Arabia	State's Public Investment Fund to lend $790 million to SABIC-Dow Chemical joint venture.	April	−17%	117.6*	14,050	May	32,219†	+15%	11.5	
United Arab Emirates	Federal government has established industrial bank to finance private sector projects.	April	−21%	19.4*	23,000	May	2,953†	+24%	4.0	

Africa

Middle East

*1980 †Excluding state reserves

BLE COPY

Will High Unemployment Undo Disinflation?

With unemployment holding at 9.5%—the highest rate since 1941—and threatening to move higher, there so far have been remarkably few voices raised in favor of expansive policy actions to stem the rising jobless rate. To the contrary, political pressure to reduce federal spending and maintain current monetary policy continues because of fears of the possible future inflationary potential of the huge government deficits. There are some warning signs, however, that public opinion may be shifting, and calls for more stimulative fiscal and monetary policy could become louder and more common. Such a policy switch would, of course risk losing some of the gains made against inflation.

Part of the reason that unemployment is so high during the current slump is the extraordinarily high rate of 6% at the end of the last major expansion. During the 1950s and 1960s, 3%-4% was the prevailing rate before a downturn. The secular increase in the underlying unemployment rate during the 1970s can be attributed to a variety of government programs that reduced the burden of being unemployed, including more generous unemployment insurance. Shifts in the composition of the labor force—toward groups that change jobs more often and thus have higher recorded rates of unemployment—also played a role.

Taking this higher base into account, the increase in unemployment in the past two and a half years has been a normal cyclical development. The average increase in the unemployment rate in the last three recessions was 3.2 percentage points. So the 3.5-percentage-point increase so far during the current slump is only slightly worse than average.

Although the total increase in unemployment is not exceptional in terms of past recessions, the length of time over which the rise occurred is much longer than usual. Moreover, the average duration of unemployment has risen to 16.5 weeks, higher than in any year since 1950.

What may have made the cost of recent unemployment bearable to both policymakers and the unemployed is the growing realization that expansive fiscal and monetary policies in the past made only temporary inroads on unemployment, and that sustainable, non-inflationary growth in the private sector offers better prospects for permanently lower unemployment. But with the current success of the anti-inflationary efforts, these groups may now shift their focus to hopes for a drop in the unemployment rate. If the widely anticipated recovery fails to take hold in the second half of the year—or is so weak or short that unemployment continues to rise—calls for additional government spending or a less restrictive monetary policy can be expected to grow much louder. If they are heeded, however, the consequences are predictable: a reacceleration of inflation, with no more than a temporary reduction of unemployment.

F PAYMENTS		MONEY AND BANKING							COUNTRIES
IMF mil-lollars	current influences on payments	12-month changes: latest data	consumer prices	latest data	money supply(M1)	exchange rate in U.S. dollars July 14, 1982	change from year earlier	current monetary conditions	
0	Oil output averaged 649,000 b/d Jan.-Apr., 26.9% below year earlier period.	Dec. '80	+10%	Nov.	+18%	.2270	+ 1%	Islamic Development Bank to lend $15 million.	Algeria
0	Arab lenders supply financing for $55 million Gaborone international airport.	Oct.	+14%	Feb.	+29%	1.0800	— 4%	Commercial bank liquidity is tight.	Botswana
8	Soon-to-be exploited iron ore deposits at Kribi should boost exports.	Aug.	+ 9%	Dec.	+24%	.002886	—16%	Liquidity appears adequate.	Cameroon
0	Three significant Gulf of Suez oil discoveries made in 1982 first quarter.	Jan.	+11%	March	+31%	1.2000	—16%	National Bank offers $30-40 mn. of floating rate Eurobonds.	Egypt
-	Heavy interest payments on foreign debt keep current account in deficit.	n. a.	—	—	—	.0440	— 4%	Severe foreign exchange shortage continues.	Guinea-Conakry
9	Coffee harvest down in 1982, but huge stocks will buffer exports.	Jan.	+13%	Dec.	+ 6%	.002886	—16%	Government credit requirements high.	Ivory Coast
8	No significant pick-up in exports foreseeable this year.	May '81	+39%	—	—	.002955	—14%	Cash flow problems continue.	Madagascar
6	Phosphate rock avgd. $44.67/ton in 1st qtr.—9.8% below 4th qtr. 1981.	Dec.	+13%	Dec.	+15%	.1900	+ 5%	Agreement signed for $70-million medium-term Euroloan.	Morocco
0	Import restrictions continue in view of depleted foreign exchange reserves.	Dec.	+17%	Feb.	+ 5%	1.4700	— 4%	IMF loan of $730 million helps replenish reserves.	Nigeria
0	Weaker rand and 10% import surcharge have begun to restrain imports.	April	+17%	March	+38%	.8700	—23%	Credit expansion to Land Bank boosts money supply.	South Africa
0	Price discounting early in the year raised cotton sales despite depressed market.	May '81	+27%	March	+29%	1.1200	—44%	Net foreign asset position has worsened sharply.	Sudan
0	Gov't aims to increase annual phosphate output to 6.8 mn. tons by 1986.	Dec.	+11%	March	+16%	1.8400	—10%	Saudi development fund to lend $51 mn. for water projects.	Tunisia
0	Tobacco earnings in 1982 down sharply owing to lower prices.	Sept.	+15%	Sept.	+ 8%	1.3600	— 4%	Foreign exchange availability extremely tight.	Zimbabwe
0	Budget projects 1982/83 oil revenues of $10.6 billion, 40% below fiscal '81/'82.	Dec. '80	+ 9%	April	+84%	3.4900	— 2%	Corporation set up to oversee official foreign investment.	Kuwait
0	Crude-oil exports holding steady.	n. a.	n. a.	Feb.	+27%	2.8935	0	Local banks lend $21 million for oil refinery project.	Oman
0	Oil output averaged 328,000 b/d Jan.-Apr., down 35% from same '81 period.	n. a.	n. a.	Sept.	+17%	.2748	— 1%	Money supply expanding steadily.	Qatar
0	Second quarter Aramco oil output estimated at 6.3 mbd, vs. 7.9 mbd in first.	Dec.	+ 2%	Sept.	+17%	.2940	0	Riyal devalued to 3.44 per dollar from 3.43.	Saudi Arabia
0	Exports of condensates from Sharjah to start in July.	n. a.	n. a.	March	+22%	.2740	0	Growth of credit to private sector slows.	United Arab Emirates

World Interest Rates

market rates as of July 14, 1982; bond yields as of July 9, 1982

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	12.00	16.50	12.187 intervention rate	14.00	9.50	7.50	19.00 penalty rate 22.00	8.00	5.50*	5.50
Day-to-Day Money	13.00 July 15	17.00	12.625	15.00	15.00	9.00	20.00	8.625	4.25* 1-month Euro-Swiss fr. rate	7.438
Treasury Bills 91-day, Middle Rates	11.97 discount basis	15.90	11.875	15.25	n. a.	n. a.	17.601 78 days	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	13.38 finance paper discount basis	16.65 finance paper 15% tax w/h	11.357	13.90 Certified	15.69 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	13.75	16.55 15% tax w/h	11.875	13.90 Certified	not traded	9.40	21.90	no market	5.063*	no market
Government Bonds Long-term, new and old issues, average yield	13.64	16.50	12.88	10.73 20% tax w/h	15.41	9.47	20.94	10.63	5.16†	8.20
Industrial Bonds prime, long-term, new and old issues, average yield	14.80 Aa Industrials	17.625	14.40	14.33	16.57	9.62	20.48	11.47	6.062†	6.72
Bank Short-Term Rate to Best Borrowers (prime rate)	16.50	18.25	18.25	17.50	16.60	12.00	21.75 ½ qtrly fee on outstdng.	10.50	9.00*	6.00
Bank Time Deposits 3-month	14.00 Cert. of Dep.	16.35	16.35	14.90	14.625	9.25	11.50	9.125 large deposits	5.25* residents only	3.75 20% tax w/h
Eurocurrencies 3-month, asked	14.948	16.75	16.75	no market	15.688	9.063	no market	9.063	4.875*	7.438
Exchange Rates—in U.S.$ rates floating against the $	—	.7886	1.724	.0210	.1444	.4011	.000717	.3635	.4701	.00391
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	1.678 *D*	2.595 *P*	.285 *D*	.554 *D*	6.086 *P*	5.579 *D*	5.945 *P*	10.684 *P*	7.586 *P*

Eurodollar Deposits
(London, interbank, bid)
July 15

7-day	13.625
1-month	14.188
3-month	14.688
6-month	15.938

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−2.337
U.S.-Canada Treasury Bills	−1.436
U.S.-Canada Finance Co. Paper	−1.369
Eurodollars-U.K. Local Auth. Deposits	−0.158

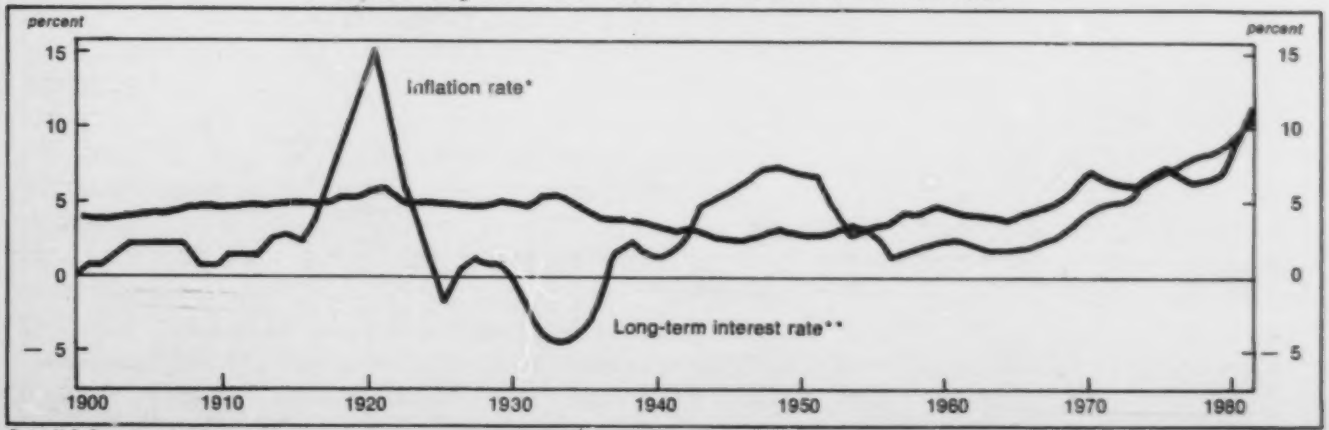
Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	15.375
Over 7 yrs.	15.625
DM Bonds	
7 yrs. and under	9.375
Over 7 yrs.	9.50

Gold Price
London afternoon fixing
352.75
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.
*Market rates as of July 7, 1982. †Bond yields as of July 2, 1982.

A history of U.S. interest rates and inflation



Data: U.S. Department of Commerce

* Five-year moving average of yearly percentage change in consumer price index.
** Average annual rate of high-grade municipal bonds.

The Inflation-Interest Rate Link Revisited

The question of why U.S. interest rates have not fallen as fast or as far as the inflation rate has confounded American politicians and perplexed economists, casting serious doubts over long-held theories of how inflation influences interest-rate movements. Businesses and consumers still rely heavily on the inflation outlook and its probable effect on interest rates in financial decision making. But the recent failure of disinflation to be translated immediately into lower rates has prompted a number of observers to dismiss this relationship as having limited significance. A review of how the two variables have interacted in the past, however, suggests that the current puzzle stems not so much from shortcomings of the underlying theory as from misunderstandings of how expectations of future inflation—a key element of the theory—are formulated and revised.

The traditional explanation of the link between interest rates and inflation can be traced to theoretical and empirical work done in the 1920s and 1930s by Irving Fisher, a leading American economist of that period. Fisher held that interest rates can be separated into two components: a "real"—or inflation-adjusted—rate of return on investment, and a premium that compensates investors for the expected change in the purchasing power of money invested. Proponents of this view maintain that the "real" component—determined by savings preferences, the marginal productivity of capital, and the long-run prospects for growth—is essentially stable over long periods of time. Therefore, Fisher's theory assigns the predominant role in explaining interest-rate movements to the second component: expected inflation.

Historical data on interest rates and inflation suggest the importance expectations played in Fisher's thinking. As the chart on page 6 illustrates, there was little apparent correlation between observed inflation and interest rates during the period in which he worked. Although inflation expectations have been the subject of intense investigation and debate since Fisher's time, disagreement persists as to how they are formed, how quickly they are revised, and how they can best be measured.

Some researchers have simplified Fisher's model to conclude that interest rates should, in fact, follow observed inflation rates. This modification, however, requires a particular specification of the way in which inflation expectations are formed—"adaptive expectation"—which assumes that the market's forecast of inflation is based on no more than the history of inflation itself. If this were the case, then inflation expectations would continuously lag actual changes in the price level and interest rates would follow movements in inflation—again assuming that the "real" component of rates is relatively stable.

The adaptive-expectations hypothesis obviously fails to explain the disjointed behavior of interest rates and inflation over much of the period covered by the chart. This approach suffers from a more fundamental shortcoming, however, in that it fails to take account of the efficiency of the financial markets in their use of other information that might indicate a change in the future course of inflation.

Monetary regimes

Historically, one of the principal influences on the market's formation and adjustment of inflation expectations has been the existing monetary regime. For example, in the years prior to 1933, U.S. monetary policy was, for the most part, subject to the discipline of a freely convertible gold standard. Under such a commodity standard, the money supply was not under the control of a government monetary authority that stood to benefit either from a gradual inflation or from the prevention of major price declines. Financial market participants were therefore likely to view price shocks as only temporary, without revising their longer-run expectations of future inflation. Periods of rising prices were bound to be followed by falling prices, and vice versa, as demand adjusted to a relatively fixed supply of money; borrowers and lenders saw little need to adjust interest rates for these accepted, self-correcting swings in the value of money. Hence, over this period there was no significant correlation between price changes and interest rates.

Interest rates subsequently seemed to move in a manner oblivious to the sharp price increase that followed the suspension of gold convertibility in 1933 and continued through the second world war. Government credit controls certainly played a part in impeding an adjustment of rates to the inflation outlook, but once again the expectations underlying that outlook were crucial. Market participants expected that the transition to a peacetime economy would be marked, as such transitions had been in the past, by a reversal of the steep wartime increases. Thus, a complete adjustment of rates to prevailing levels of inflation was seen as unnecessary. These expectations were not completely realized, however, as the world's industrial economies embarked on a new path of monetary management, heralded by the Bretton Woods agreement of 1944.

The postwar era has featured a succession of monetary regimes, with differing impacts on the formation of inflation expectations. The Bretton Woods system

The Inflation-Interest Rate Link Revisited *(continued from page 7)*

was marked by an agreed-upon world reserve currency—the dollar—that was not only part of a worldwide fixed exchange rate system but was also convertible, for foreign holders, into gold at an official price. The U.S. monetary authorities—the Federal Reserve—faced severe constraints in their management of the money supply under what was essentially a worldwide gold standard. Inflation expectations were accordingly low over this period, until the first signs appeared in the mid-1960s of the Federal Reserve's attempt to evade the guidelines set forth in the agreement. When it became clear—from the restrictions on convertibility imposed in 1968—that the Bretton Woods system had little chance to survive, financial markets could no longer rely on the self-correcting mechanism of a commodity standard in forming their expectations of inflation. Consequently, a progressively larger share of each subsequent money-supply shock found its way into expectations of future price changes.

The disintegration of the Bretton Woods system was confirmed by the closing of the government's gold window in 1971 and the free floating of the major currencies in 1973. This left the Federal Reserve managing a purely fiat currency, with predictable consequences: The rapid money-supply expansion—unprecedented in the post-war period—was quickly incorporated into expected inflation, as there was little reason to believe that this expansionary policy would be reversed. This resulted in the closest correlation of observed inflation and interest rates in recent history.

Finally, for their impact on the formation of inflation expectations, the events of October 6, 1979, may be said to have ushered in a new monetary regime—the one still in effect today. The date marked a shift in the operating strategy of the Federal Reserve, committing it to a policy of direct control of the monetary aggregates. The new strategy has been implemented at the cost of unprecedented interest-rate volatility over the short run. This is because the new operating tactics, without necessarily affecting inflation expectations directly, have introduced a greater degree of uncertainty over the Fed's reaction to short-run changes in the supply and demand for money and credit.

Since this strategy was enacted, however, the Fed has also given notice to the financial markets that money growth significantly outside its targets will no longer be tolerated and should not be incorporated as a permanent shift in revised inflation expectations. Nevertheless, beyond this perceived strengthening of the Fed's resolve to slow the growth of the aggregate money supply, there still exist no constraints that guarantee such an outcome, other than the self-discipline of the monetay authorities themselves. Resolve and self-discipline in the past have proved to be a fragile basis for monetary policy. Consequently, every policy statement or action of the Fed has been subjected to close scrutiny. And although borrowers and lenders may have adjusted their inflation forecasts downward, they are highly uncertain of the accuracy of these forecasts.

The missing link: uncertainty

This element of uncertainty has suggested to some economists that Fisher's inflation expectations hypothesis, although useful as far as it goes, has overlooked a third component that may be vital in explaining the situation in which the financial markets currently find themselves. This third component is a measure of the uncertainty with which inflation expectations are held—based on the assumption that lenders must be compensated not only for the expected change in the value of their funds over the investment period, but also for the uncertainty with which they view those expectations. This uncertainty is directly related, along with the real and expected inflation components, to interest rates.

Thus, it would be a mistake to dismiss altogether the significance of inflation expectations in determining interest rates. Fisher's theory—with some updating—still provides a useful framework for analyzing the current behavior of interest rates relative to the outlook for inflation. Specifically, if financial decision-makers are confident that the market's expectation of inflation has been revised downward, then the failure of rates to follow focuses attention on the likely increase in uncertainty surrounding these revised expectations. It may well be that the Federal Reserve, having succeed in its aim of lowering current and expected inflation, now faces the difficult task of reducing the uncertainty clouding this new outlook.

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